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SUBJECT: LATVIA: POLITCAL, ECONOMIC AND TECHNICAL COMPLICATIONS
REMAIN OBSTACLES TO PAREX BANK SALE

REF: A. RIGA 516, B. RIGA 484, C. STOCKHOLM 632, D. RIGA 413

RIGA 00000526 001.2 OF 002

¶1. (SBU) Summary: Political, economic and technical barriers may impede the quick restructuring and sale of Parex Bank, which is a key to Latvia's economic recovery. Latvia's other state-owned bank, Land and Mortgage Bank, is facing a deteriorating loan portfolio and may need additional government capital infusions. End summary.

Background

¶2. (U) Parex Bank collapsed in November 2008 following a run on its deposits in the wake of the global financial crisis. The government took a majority share of the bank in a deal that has been the subject of widespread scrutiny in the press and a recent State Auditor's Office report. The State Prosecutor's Office announced a criminal investigation on October 16 into the government's initial handling of the takeover. The collapse of Parex precipitated Latvia's approach to the IMF/EC for assistance. As a precondition for IMF/EC assistance, the government was forced to take complete control over the bank. Following a series of audits and extensive review of the bank's balance sheet the EBRD recently took a 25 percent stake in Parex.

Restructuring and Sale

¶3. (SBU) Parex's management will present a draft restructuring plan to the Cabinet on October 27-28 and is hoping to secure the European Commission's sign-off on the same plan by November 15. In a meeting with Ambassador Garber, Parex Chairman Nils Melngailis outlined an ambitious plan to sell Parex's restructured components (a commercial bank and a non-core, non-performing asset fund) within 6-9 months. Melngailis hopes to limit the government's liability exposure to LVL 400 million (USD 800 million), down from the current level of LVL 1.2 billion (USD 2.5 billion), which includes equity, deposits, and sovereign credit guarantees on syndicated loans. This scenario would see up to LVL 800 million (USD 1.6 billion) returned to the Latvian treasury, substantially improving the 2010 budget outlook if completed along Melngailis' expedited timeline.

¶4. (SBU) Given the domestic and international economic climate and continuing uncertainty about ongoing investigations or potential litigation by former shareholders, there appears to be very limited commercial appetite for Parex, either as a whole entity or for its restructured components. In contrast to Bank of Latvia Governor Ilmars Rimsevics (see reftel A), Irena Krumane, head of the Latvian financial regulatory authority (FCMC), the PM's office and Melngailis all believe that the bank cannot be sold as a single entity. Melngailis said that a number of third country banks are looking at Parex as a gateway into the European banking market, but noted that none of these banks are Russian as many have speculated. However, he admitted that the ongoing investigations have already scared away a couple of investors. Melngailis said there is, nonetheless, some interest in the non-performing asset fund.

Specifically, Parex is hoping that the IFC will come in as the anchor investor in the fund, which was valued by Melngailis at roughly LVL 1 billion (USD 2 billion). Ultimately, Latvia's ability to recoup its remaining exposure to the fund will depend on asset price fluctuations over the next 5-7 years.

Land and Mortgage Bank: a Second Parex?

¶5. (SBU) The FCMC told us that Latvia's other state-owned bank, the Land and Mortgage Bank (LMB), may also soon run into serious difficulties. Melngailis independently confirmed that LMB's problems are much worse than currently reflected on its balance sheet. According to the FCMC, without capital injections, by mid-2010 the bank's capital adequacy ratio will be deficient. As a result, the government is considering a restructuring for LMB. Parex and the PM's office are both considering the potential of combining the bad assets from LMB (LVL 1.5 billion/USD 3 billion) into the non-performing asset fund created for Parex. However, the FCMC said it would not support such a move, citing transparency and complications involving the ERBD's investment in Parex.

Sale Key to Recovery

¶6. (SBU) The successful restructuring and sale of Parex remains a key to Latvia's economic recovery. The sale of Parex would immediately improve the country's credit rating and ameliorate the 2010 budget outlook. Failure would put additional pressure on the already strained budget as the bank will likely need additional capital injections and the government is still on the hook for its syndicated loan guarantees. According to the FCMC, Parex is too weak to pay any share of the roughly LVL 200 million (USD 400 million) installment due in February, but Melngailis believes Parex could pay LVL 100 million (USD 200 million).

Political Maneuvering Could Delay or Derail Progress

¶7. (SBU) The PM's office expressed concern that some political parties may seek to delay action on Parex's restructuring out of fear that the current government could claim credit and strengthen their electoral prospects. While there is widespread political agreement that the sale is a key to Latvia's economic recovery, the political instability of the current coalition, coupled with the highly charged political debate over how the takeover was handled, may all combine to delay or derail any deal. Such a scenario would also act as a drag on any incipient economic recovery.

GARBER